

Andy Laperriere, CFA 202 872 5261 [alaperriere@isigrp.com](mailto:alaperriere@isigrp.com)  
Roberto Perli 202 872 5268 [rperli@isigrp.com](mailto:rperli@isigrp.com)  
Melissa Loesberg, CFA 202 872 5262 [mloesberg@isigrp.com](mailto:mloesberg@isigrp.com)  
Fax 202 530 5804

1130 Connecticut Avenue, NW  
Suite 625  
Washington, DC 20036

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# ECONOMIC POLICY OUTLOOK

March 2013

**Andy Laperriere**



## 2013 Major Policy Themes

- **Fiscal Policy.** The budget battles aren't going away as Congress faces three major issues that need to be addressed during the next several months: the sequester, funding the government for the rest of the fiscal year, and raising the debt ceiling. Republicans seem determined to shut off the sequester only in exchange for other spending cuts, especially entitlement savings. Democrats have demanded more tax increases to accompany any spending cuts that would delay or replace the sequester. Yet Republicans are insisting that there will be no more tax hikes. The sequester will take effect and probably last for at least a couple of months. The odds of a grand bargain have dropped considerably and the odds of being downgraded by the credit rating agencies have increased substantially. Health care and defense are the sectors with the most at stake in these budget battles.
- **Sector Issues.** Other than budget-related issues, the rest of the congressional agenda will have less of a market impact. Much of the controversial and high-profile legislation President Obama is interested in moving through Congress involve social issues with limited financial market implications, including immigration reform and gun control. The more important policy developments may come on the regulatory front, including implementation of the health care law and environmental regulations. Implementation of the health care law will be important, not only for the impact on various health subsectors, but also how various industries are impacted by the health care mandate and the cost of health care coverage.
- **US Monetary Policy.** The Fed is likely to continue with QE until the labor market is on a firmer footing, which likely means payrolls of about 200,000 per month on a consistent basis and an unemployment rate declining because of continued job creation, not because of sluggish participation. As of now, at least half the FOMC thinks that point will be reached sometime in the second half of this year. If that proves true, QE will end because the economy is in better shape, and as such it would be a bullish, not a bearish development.

That said, the Fed will also pay careful attention to the costs of QE. Expectations that the Fed's balance sheet will expand by very large amounts (say, more than \$1 trillion from here) regardless of economic conditions are probably unwarranted.

Even if QE ends this year, rate hikes likely remain a long way away. If the sequester kicks in on March 1 as now appears probable, the Fed might revise down its forecast somewhat. That might induce the Fed to think the 6.5% unemployment threshold will be reached later than currently thought and thus to postpone the date of the first rate hike by a couple of quarters, to late-2015.

- **European Policy.** The ECB most likely will continue to be as supportive as it can of the European financial system. That means a willingness to lend with few limits to banks and willingness to buy bonds of any country that will accept ECB conditions. Against this backdrop, we don't expect risk to come back as forcefully as it has in the past.

However, the ECB will be reluctant to provide more broad-based monetary accommodation. The ECB is doubtful that another rate cut could accomplish much in macro terms and is

likely studying alternative options to boost the flow of credit in the economy. But alternative options are controversial and will be adopted only if the macro outlook deteriorates more.

On the political front, Spain will sign an MOU only if forced by markets, but with the ECB ready to intervene Spanish yields may not shoot up much. A potential catalyst could be a deteriorating macro outlook that will cause Spain to miss its fiscal targets again. On the political front, if Monti retains influence on the next government (the odds of which are increasing), Italian markets should stabilize further. The German elections are likely to result in a coalition that will be focused more on European stability and less on austerity.

- **Japanese Policy.** With the ascension of Abe to the prime ministry, unlike most of the developed world Japan is likely to see both expansive monetary policies and expansive fiscal policies. The BOJ adopted a formal inflation target of 2% and is likely to continue to expand its QE program in order to achieve it. On the fiscal side, Abe is likely to follow through with his announced intention of providing additional significant fiscal stimulus.

This combination is likely to continue to weigh on the yen in the near term. Over the longer term, however, promoting sustained growth and fighting deflation in an economy plagued by an adverse demographic backdrop will be challenging, and so will be sustaining a weak currency.

- **Politics.** Given President Obama's stronger-than-expected election victory and because Democrats retained control of the Senate, Obama has the political capital to set the agenda in Washington. However, the vast majority of Republicans hail from states and districts where Obama lost by large margins, so his ability to sway public opinion to influence Republican votes in Congress is extremely limited. The most consequential elections this year will be the gubernatorial contests in New Jersey and Virginia, which are often bellwethers of the mid-term elections.
- **Geopolitics.** Geopolitical developments are especially difficult to predict because they are often precipitated by decisions made by non-democratic governments, but events in Iran or Syria could prove to be more eventful than now seems likely.

### Key US Fiscal Policy Dates

<u>Date</u>	<u>Event</u>
March 1	Sequester begins.
Mid-March	Obama releases budget.
March 27	Continuing resolution expires.
April 15	Deadline for annual budget resolution.
May 19	Deadline for raising debt ceiling.

### ISI Estimates of 2013 Fiscal Headwind

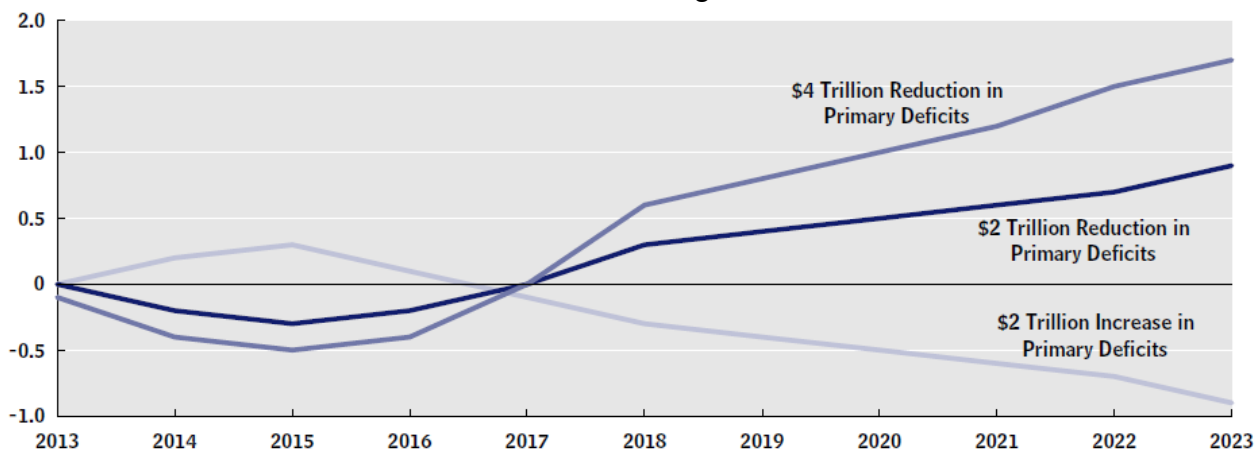
(in billions of dollars)

<b>Provision</b>	<b>2013 Impact*</b>
Discretionary spending	84
Health care law taxes	21
Payroll tax cut	116
Bush tax cuts for wealthy	30
Sequester	60
<b>Total</b>	<b>\$311</b>

\* Calendar year. Sources: Congressional Budget Office, OMB, Joint Committee on Taxation, Treasury, and ISI analysis. Assuming sequester takes effect.

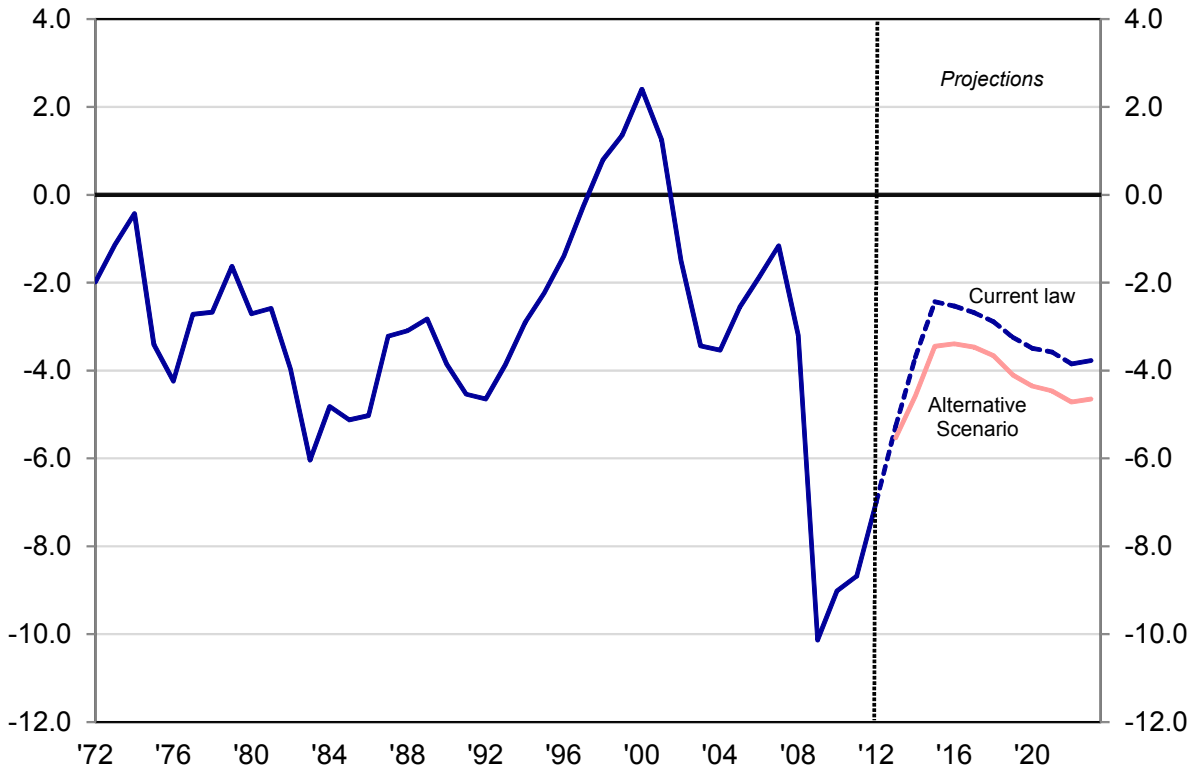
### Effects of Various Budget Plans on Real GNP Relative to Projections Under Current Law

Calendar Years 2013-2023, Percentage Difference from Baseline



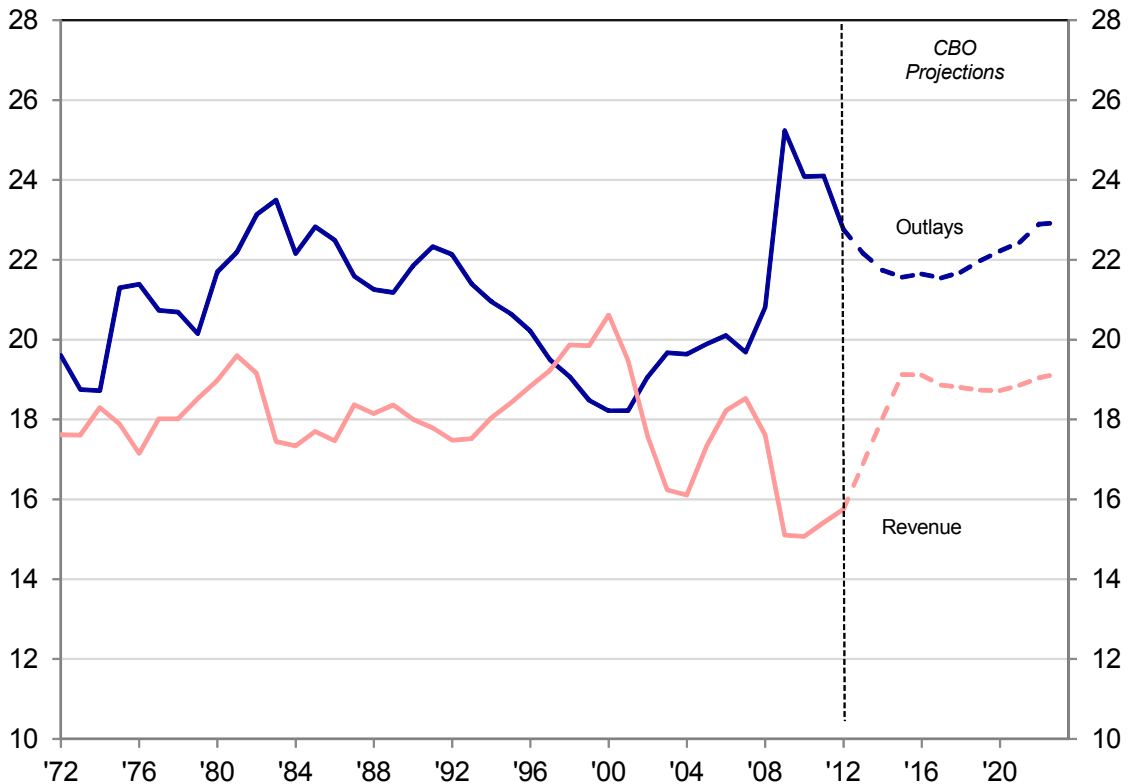
Source: CBO. Note: Prime deficit equals revenues minus noninterest spending.

**Budget Deficits as Share of GDP - Current Law vs. Alternative Fiscal Scenario (Current Policy)**



Sources: CBO, ISI. The alternative scenario assumes: the sequester doesn't take effect, doctor reimbursement rates under Medicare aren't cut, certain expiring tax provisions are extended, and the costs in Afghanistan continue to decline (which reduces the deficit compared to the baseline scenario).

**Federal Revenues and Outlays as Share of GDP**



Source: CBO.

## ISI U.S. Forecast

	2012				2013	
	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>	<u>1H f</u>	<u>2H f</u>
<b>Real GDP *</b>	2.0%	1.3%	3.1%	-0.1%	2.0%	3.0%
<b>GDP Price Deflator *</b>	2.2%	1.5%	2.8%	0.6%	1.5%	2.0%
<b>Nominal GDP *</b>	4.2%	2.8%	5.9%	0.5%	3.5%	5.0%
<b>S&amp;P EPS</b>	\$97	\$102	\$96	\$101	\$103	\$107
<b>Unemployment Rate**</b>	8.2%	8.2%	7.8%	7.9%	7.8%	7.5%
<b>Payroll Employment</b>						
<b>Avg. Monthly Ch.</b>	226k	67k	168k	151k	150k	200k
<b>10-Year Bond Yield**</b>	2.2%	1.7%	1.7%	1.8%	2.0%	2.5%
<b>Fed Funds Rate**</b>	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%

\* Q/Q % A.R.

\*\* End of period

## CBO Economic Assumptions

Calendar years

	<u>'13</u>	<u>'14</u>	<u>'15</u>	<u>'16</u>	<u>'17</u>	<u>'18</u>
Real GDP <sup>1</sup>	1.4	2.6	4.1	4.4	3.8	2.6
Consumer price <sup>1</sup>	1.6	1.9	2.1	2.1	2.2	2.3
Unemployment rate (%) <sup>2</sup>	7.9	7.8	7.1	6.3	5.6	5.5
Payroll employment (monthly chg, thousands) <sup>2</sup>	105	182	222	220	153	88
3mo Treasury bills <sup>2</sup>	0.1	0.2	0.2	1.5	3.4	4.0
10yr Treasury notes <sup>2</sup>	2.1	2.7	3.5	4.3	5.0	5.2

Source: CBO. <sup>1</sup> Year to year percentage change. <sup>2</sup> Calendar year average.

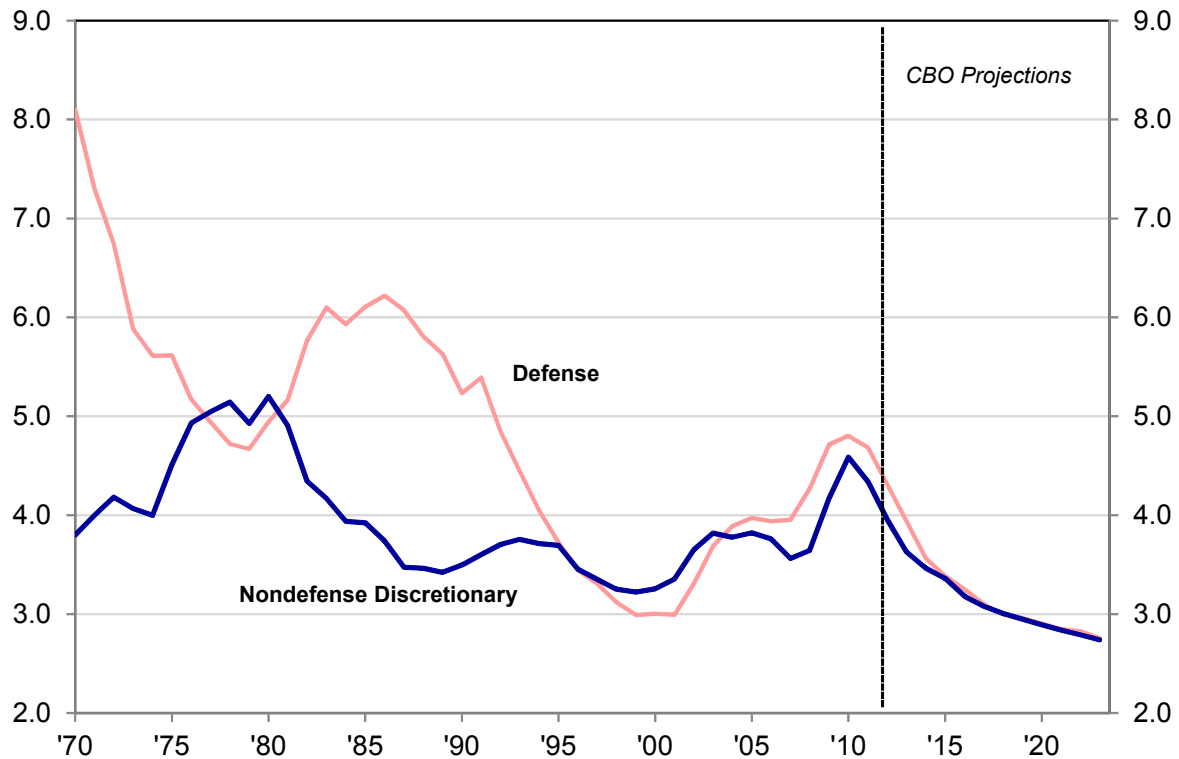
## Comparison of Economic Assumptions

Calendar years

	<u>'13</u>	<u>'14</u>	<u>'15</u>	<u>'16</u>	<u>'17</u>
<b>Real GDP (Y/Y% chg):</b>					
OMB	2.7	3.5	4.1	4.0	3.8
Bloomberg Consensus	2.0	2.8	NA	NA	NA
<b>Unemployment rate (annual avgs, %):</b>					
OMB	7.7	7.3	6.7	6.2	5.7
Bloomberg Consensus	7.7	7.3	NA	NA	NA
<b>Consumer Price (Y/Y% chg):</b>					
OMB	1.9	2.0	2.0	2.1	2.2
Bloomberg Consensus	1.9	2.1	NA	NA	NA

Sources: Office of Management and Budget, Bloomberg.

### Nondefense and Defense Discretionary Outlays as Share of GDP (with sequester)



### CBO Estimates of Limits On Discretionary Budget Authority Under Caps and Sequestration in billions of dollars, fiscal years

	<u>'13</u>	<u>'14</u>	<u>'15</u>	<u>'16</u>	<u>'17</u>	<u>'18</u>	<u>'19</u>	<u>'20</u>	<u>'21</u>
<b>Caps under Budget Control Act</b>									
Defense	544	552	566	577	590	603	616	630	644
Nondefense	<u>499</u>	<u>506</u>	<u>520</u>	<u>530</u>	<u>541</u>	<u>553</u>	<u>566</u>	<u>578</u>	<u>590</u>
<b>Total</b>	1,043 <sup>1</sup>	1,058 <sup>1</sup>	1,086	1,107	1,131	1,156	1,182	1,208	1,234
<b>Effect of sequester</b>									
Defense	-43	-55	-55	-55	-55	-55	-55	-55	-55
Nondefense	<u>-30</u>	<u>-37</u>	<u>-37</u>	<u>-36</u>	<u>-36</u>	<u>-35</u>	<u>-34</u>	<u>-33</u>	<u>-32</u>
<b>Total</b>	-73 <sup>2</sup>	-92	-92	-91	-91	-90	-89	-88	-87
<b>Revised caps</b>									
Defense	501	497	511	522	535	548	561	575	589
Nondefense	<u>469</u>	<u>469</u>	<u>483</u>	<u>494</u>	<u>505</u>	<u>518</u>	<u>532</u>	<u>545</u>	<u>558</u>
<b>Total</b>	970	966	995	1,016	1,040	1,066	1,093	1,120	1,147

Sources: ISI analysis, CBO, Democratic Caucus of the House Budget Committee.

<http://democrats.budget.house.gov/sites/democrats.budget.house.gov/files/01.17.13%20sequestrations%202013%20update.pdf>

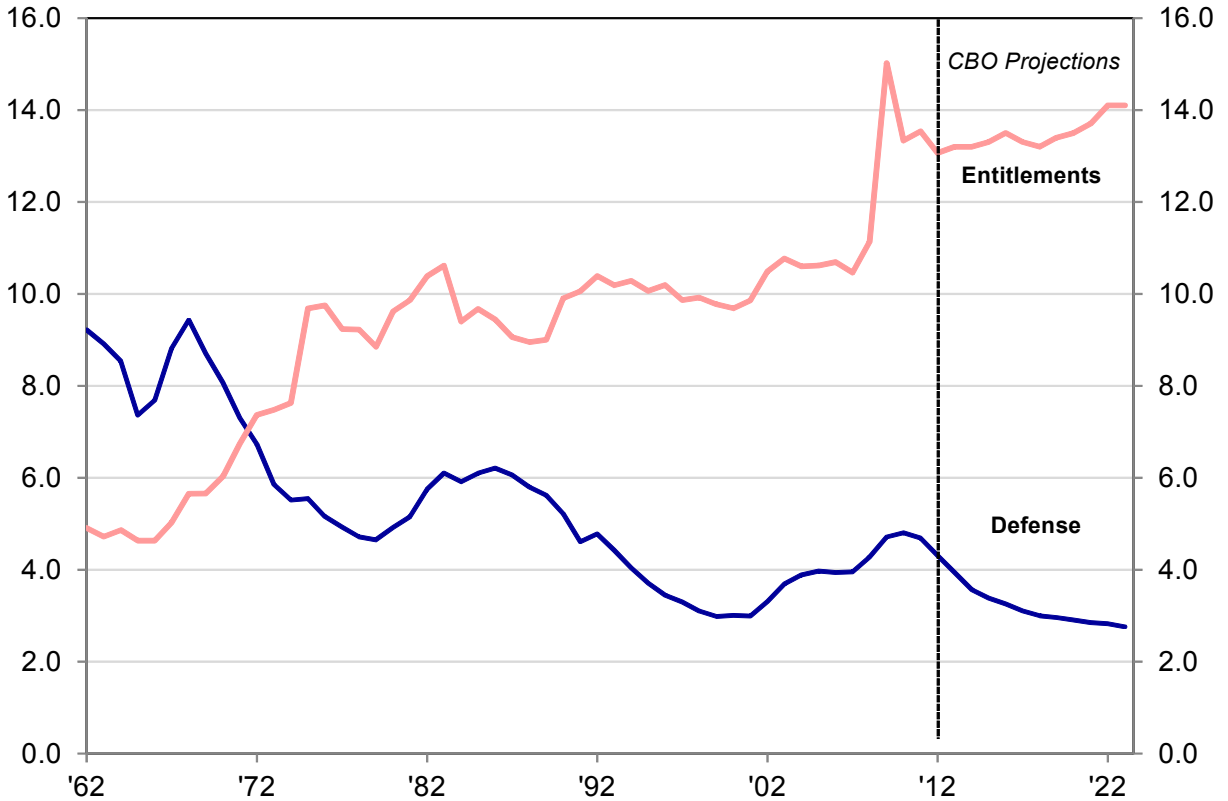
Numbers may not add up due to rounding. This table does not take into account mandatory spending.

<sup>1</sup> Under the fiscal cliff deal, discretionary caps were reduced by \$4 billion in FY13 and \$8 billion in FY14.

<sup>2</sup> The FY13 sequester was cut by \$24 billion under the deal, half from defense and half from nondefense. Most of defense is discretionary, while a third of nondefense is mandatory; therefore, roughly \$4 billion of the sequester reduction is not included.

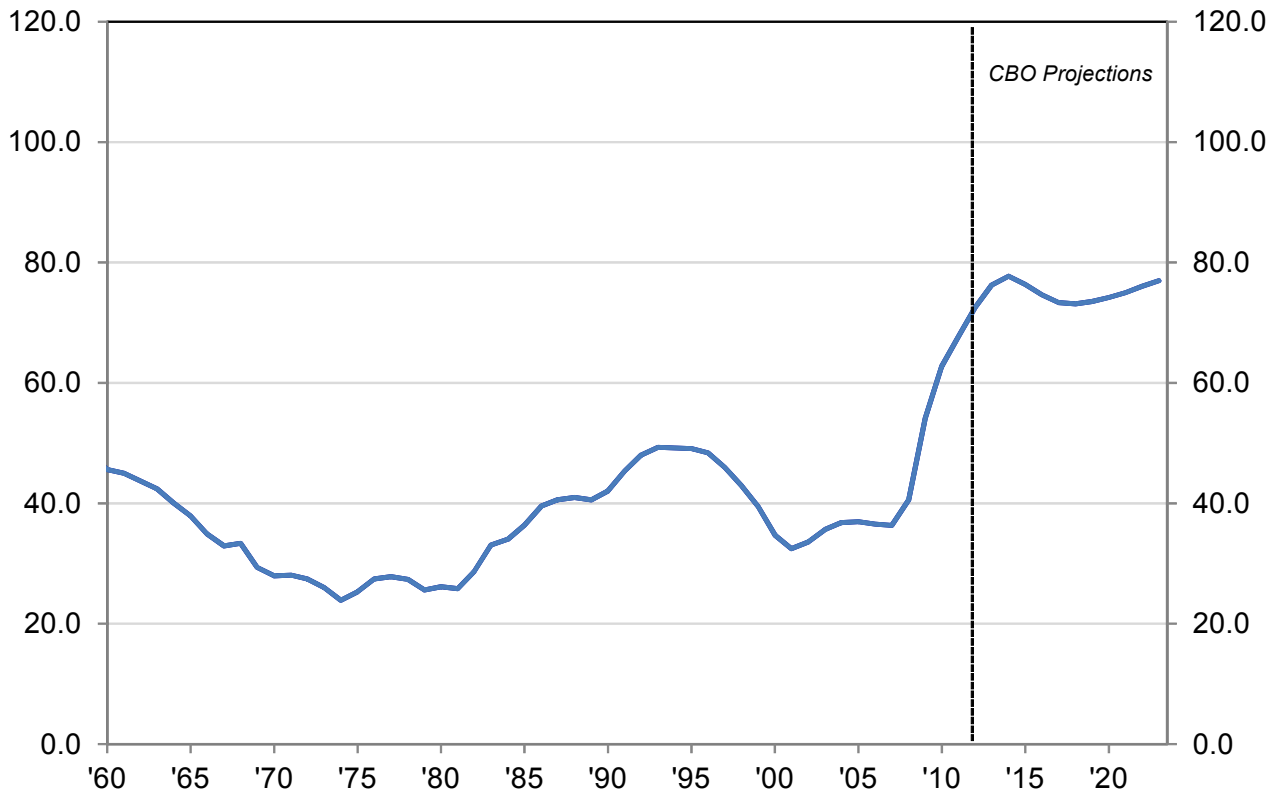


**Defense and Entitlement Spending as Share of GDP**

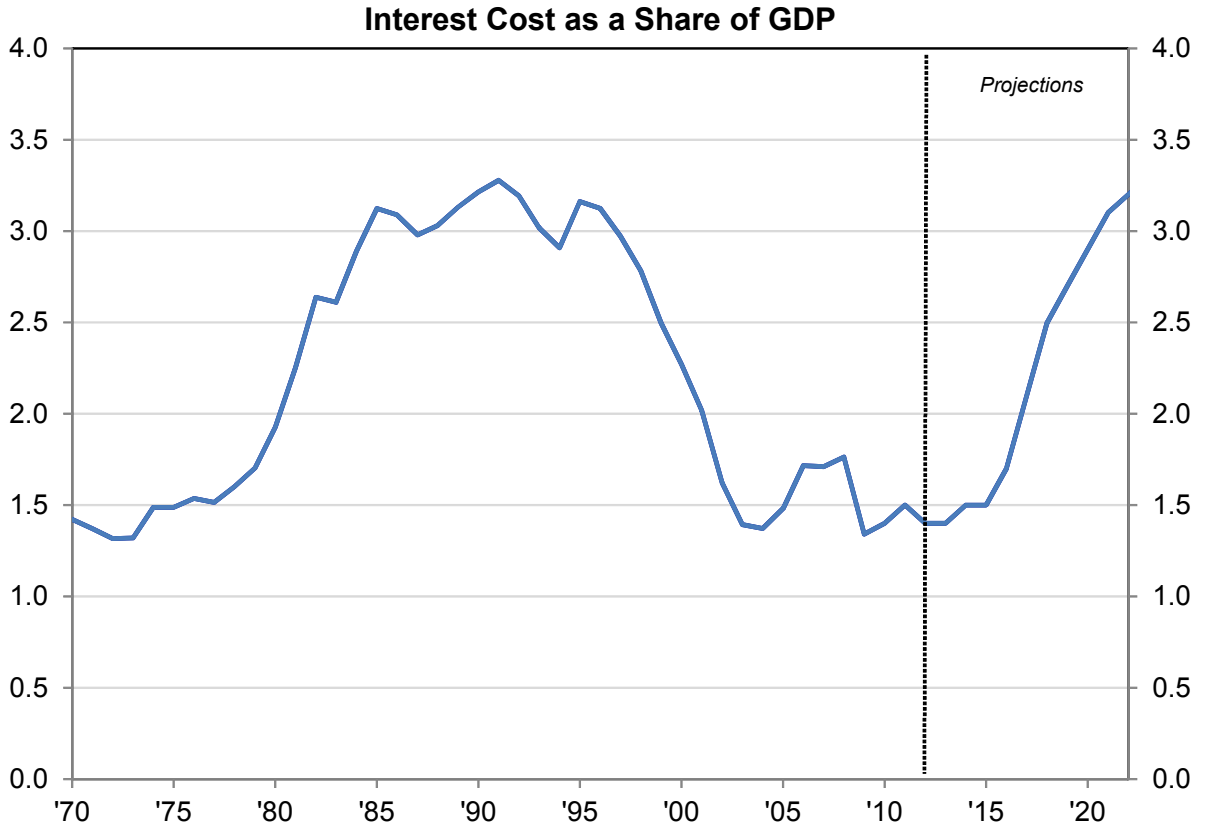


Sources: OMB and CBO.

**Federal Debt Held By The Public as Share of GDP**



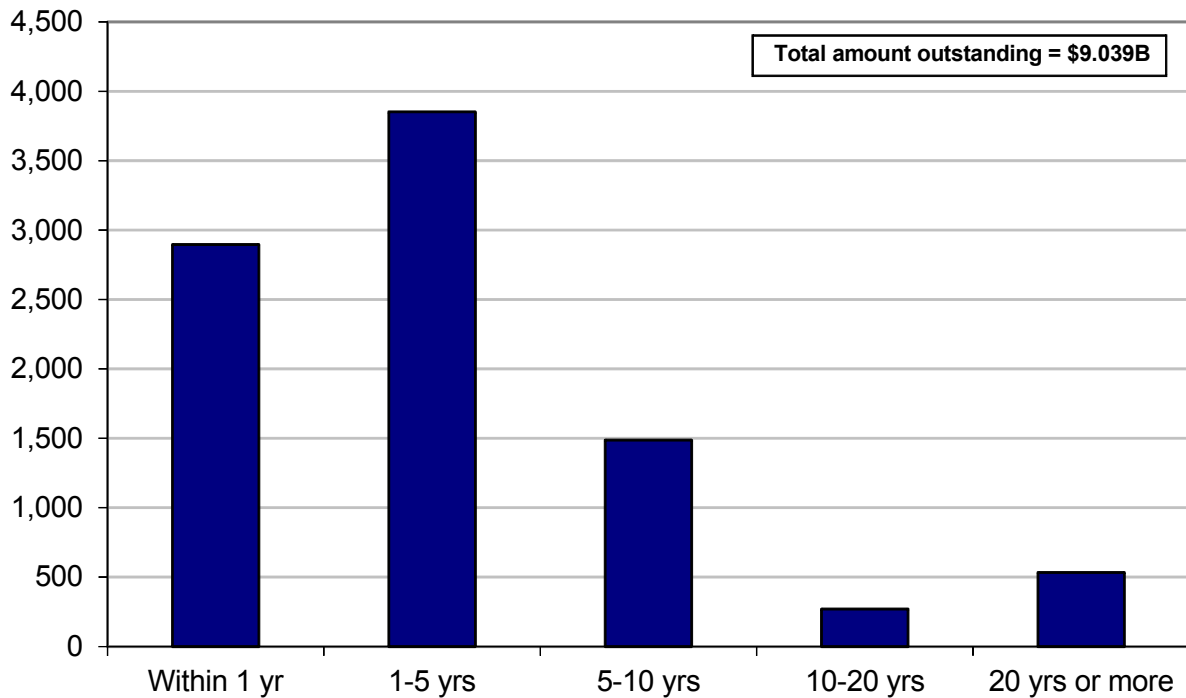
Source: CBO.



Source: CBO.

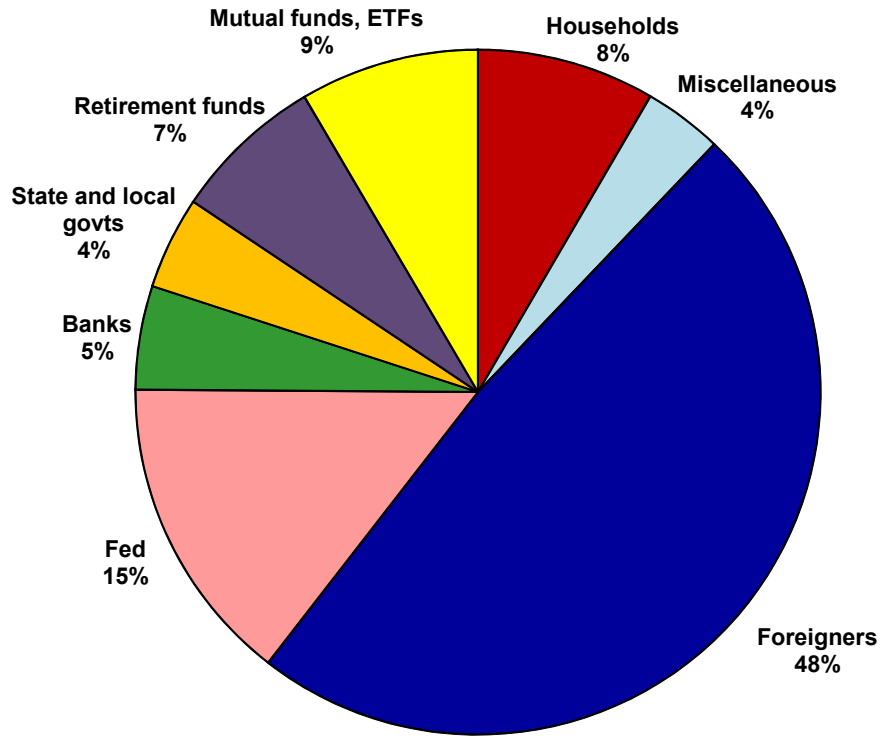
### Maturity Distribution Of Marketable Interest-Bearing Public Debt Held By Private Investors

in billions of dollars, as of September 2012



Source: Treasury Department's Financial Management Service.

**Holder Of Treasury Securities, 3Q12**



Source: Federal Reserve's Flow of Funds.

## 10

**Major Tax Proposals in Obama's FY13 Budget**

Fiscal years, deficit increases (+) or decreases (-) in billions of dollars

	'13	'14	'15	'16	'17	'13-'22
<b>Tax Hikes on Individuals</b>						
Upper income:						
Limit on itemized deductions	-27.1	-43.9	-47.5	-51.8	-57.0	-584.2
Reinstate 36% and 39.6% rates	-23.1	-32.5	-35.5	-39.1	-42.7	-441.6
Tax dividends as ordinary income	-21.5	-10.5	-15.6	-20.2	-22.3	-206.4
Reinstate limitation on itemized deductions	-4.4	-9.1	-10.0	-11.1	-12.1	-123.0
Reinstate personal exemption phaseout	-1.5	-3.2	-3.5	-3.7	-4.1	-41.9
20% rate on cap gains	-5.8	4.2	1.7	-2.3	-4.7	-36.0
Restore 2009 estate tax rate and exemption, modify rules on valuation discounts	-0.9	-10.0	-11.4	-12.4	-13.6	-136.9
Reform aviation passenger security user fee	-0.2	-1.1	-1.4	-1.7	-2.0	-18.0
<b>Corporate Tax Hikes</b>						
Reform international tax system	-9.5	-16.2	-16.8	-17.4	-18.0	-147.5
Repeal LIFO accounting rule	--	-5.5	-8.8	-8.4	-8.4	-73.8
Fee on banks	--	-3.3	-6.5	-6.5	-6.8	-61.3
Eliminate oil and gas tax breaks	-4.2	-3.7	-3.3	-3.2	-2.9	-26.9
Reinstate Superfund taxes, increase Oil Spill Liability Trust Fund by one cent	-1.5	-2.2	-2.1	-2.0	-2.2	-21.7
Increase PBGC premiums	--	-0.1	-1.8	-2.3	-2.3	-16.0
Reform treatment of insurance institutions	-0.5	-0.9	-1.0	-1.1	-1.3	-15.8
Make permanent unemployment insurance surtax	-1.0	-1.4	-1.4	-1.4	-1.4	-13.9
Tax carried interest at ordinary income	-1.3	-1.9	-1.9	-1.7	-1.4	-13.5
Repeal lower-of-cost-or-market inventory accounting method	--	-0.9	-5.6	-2.3	-1.5	-13.1
Surcharge on air traffic services	-0.6	-0.7	-0.7	-0.7	-0.7	-7.5
Require ordinary treatment of income from day-to-day dealer activities	-0.2	-0.2	-0.3	-0.3	-0.3	-2.9
Eliminate coal tax breaks	-0.2	-0.2	-0.2	-0.3	-0.3	-2.6
<b>Tax Cuts</b>						
Extend American opportunity tax credit	0.7	12.7	13.0	14.1	14.2	137.4
Enhance, make permanent R&D credit	7.0	7.8	8.7	9.6	10.4	108.5
Extend payroll tax cut through 2012	31.2	--	-0.1	0.0	0.0	31.2
Extend 100% expensing	14.8	-13.7	-10.3	-7.3	-5.4	-30.9
Expand Earned Income Tax Credit	0.1	1.4	1.5	1.5	1.5	14.0
Expand child, dependent care tax credit	0.3	1.1	1.1	1.1	1.1	10.2
Extend, modify certain renewable energy incentives, such as PTC for wind	0.6	1.8	0.7	0.3	0.1	3.9
Reform, extend Build America bonds	0.1	0.1	0.1	0.1	0.1	1.1

Source: Office of Management and Budget (OMB). Note: 0.0 = negligible amount.

**Major Tax Proposals in Obama's FY13 Budget Cont'd**

Fiscal years, deficit increases (+) or decreases (-) in billions of dollars

	'13	'14	'15	'16	'17	'13-'22
<b>Tax Cuts Cont'd</b>						
Temporary 10% tax credit for new jobs and wage increases	12.6	1.1	1.2	1.0	0.9	18.4
Automatic enrollment in IRAs, double tax credit for small employer plan startup costs	--	0.7	1.2	1.3	1.4	15.0
Manufacturing Communities tax credit	0.0	0.1	0.2	0.4	0.5	4.4
Additional tax credits for advanced energy manufacturing	0.8	1.3	1.2	0.4	0.0	3.5
Tax credit for production of advanced technology vehicles	0.1	0.2	0.3	0.4	0.6	2.0
Tax credit in lieu of deduction for energy-efficient commercial building property	0.4	0.5	0.4	0.2	0.1	1.7
Tax credit for medium- and heavy-duty alternative-fuel commercial vehicles	0.0	0.2	0.3	0.3	0.4	1.7
Tax incentives for locating jobs & business activity in US and remove tax deductions for shipping jobs overseas	0.0	0.0	0.0	0.0	0.0	0.1
Target domestic production activities deduction to domestic manufacturing, double advanced manufacturing deduction	--	--	--	--	--	--

Source: OMB. Note: 0.0 = negligible amount.

## Biden Framework Details

in billions of dollars

Savings (10 years)	Program	Description
<b>Health-Related Spending Cuts \$334-353 billion</b>		
\$100	Medicaid	Eliminate state gaming of Medicaid tax gimmick, place dual eligible in Medicaid managed care, and reduce funding for administrative costs.
Up to \$53	Medigap	Put new policy restrictions on Medigap plans (supplemental private insurance plans).
\$50	Skilled Nursing Facilities/Home Health	New co-payments and cost-sharing provisions.
\$38	Income Means Testing	Require upper-income seniors to pay more for health coverage.
\$19	Miscellaneous	No specifics available.
\$14-26	Hospital Bad Debt	Cut Medicare payments to hospitals for unpaid deductibles and copays.
\$14	Medical Education	Reduce Medicare subsidies to teaching hospitals.
\$14	Rural Hospitals	No specifics available.
\$8.5-16	Clinical Labs	Establish co-payments for laboratory services.
\$8	Obamacare Slush Fund	Eliminate discretionary funds in the health law.
\$5	Medicaid Durable Medical Equipment	A few different ways this can be done, but would hurt industry.
<b>Other Mandatory Savings \$264-332 billion</b>		
\$47	Civilian/Military Retirement	Reduce retirement benefits for federal workers.
\$45	Program Integrity Property Sales	Federal government would sell some excess land and buildings.
\$33	Agriculture Subsidies/Conservation	Cut farm subsidies and put limits on conservation programs.
\$30	Fannie and Freddie Fees	Increase the guarantee fees Fannie Mae and Freddie Mac charge to guarantee mortgages.
\$27	PBGC/Aviation/FAA fees	Allow the PBGC to increase both flat- and variable-rate premiums. No specifics on FAA.
\$20-25	Spectrum/Universal Service Fund	Auction off electromagnetic spectrum.
\$20	Supplemental Nutrition Assistance Program (SNAP)	Cut food stamps.
\$17	TriCare Drugs	Change the way the military health plan Tricare purchases drugs.
\$10-?	Higher Ed/ Pell grants	Cut federal student loans and the Pell Grant Program.

Sources: House Majority Leader's Office, Obama's Fiscal Commission, news reports.

## Deficit Effect Of Bowles-Simpson Fiscal Commission Plan

in billions of dollars

	2012	2013	2014	2015	2012-20
<b>Revenue</b>					
Comprehensive tax reform/failsafe	0	20	40	80	785
Raise Social Security taxable maximum to cover 90% of wages	3	5	8	12	138
15-cent gas tax hike	0	2	7	12	114
Apply chained-CPI throughout government	1	3	4	6	96
<b>Total Revenue Effect</b>	<b>4</b>	<b>30</b>	<b>59</b>	<b>110</b>	<b>1,133</b>
<b>Outlays</b>					
<i>Discretionary spending caps</i>	-49	-102	-141	-172	-1,661
<i>Social Security savings (mostly CPI adjustment)</i>	-1	-3	-5	-8	-100
<i>Health care reforms</i>					
Reform sustainable growth rate	0	-2	-3	-3	-26
Reform, repeal the CLASS Act	6	9	10	11	76
Require rebate payments from drug companies	0	-2	-6	-7	-49
Reduce spending for graduate medical education	0	-5	-6	-6	-60
Expand Medicare cost sharing, restrict Medigap coverage, create catastrophic cap	0	-10	-10	-10	-110
Enact tort reform	-1	-1	-1	-2	-17
Restrict Medicaid tax-gaming	0	-2	-5	-5	-44
Reform TRICARE for life to align with Medigap rules	0	-3	-4	-4	-38
Enact premium support pilot for federal employees	0	-1	-2	-2	-18
Other health changes	-1	-4	-5	-7	-55
<i>Other mandatory</i>					
Apply chained-CPI throughout government	-1	-1	-2	-3	-43
Reform federal civilian & military retirement	0	-1	-2	-5	-73
Reduce farm subsidies	0	-1	-1	-1	-10
Allow PBGC to set premiums	0	-2	-2	-2	-16
Eliminate in-school interest subsidies for loans	-3	-5	-5	-5	-43
Reduce fraud, other changes	-1	-2	-2	-3	-30
<b>Total Outlay Effect</b>	<b>-51</b>	<b>-138</b>	<b>-193</b>	<b>-235</b>	<b>-2,318</b>
<b>Net Interest</b>	<b>-1</b>	<b>-5</b>	<b>-16</b>	<b>-33</b>	<b>-673</b>
<b>Total Effect on the Deficit</b>	<b>56</b>	<b>173</b>	<b>268</b>	<b>377</b>	<b>4,125</b>

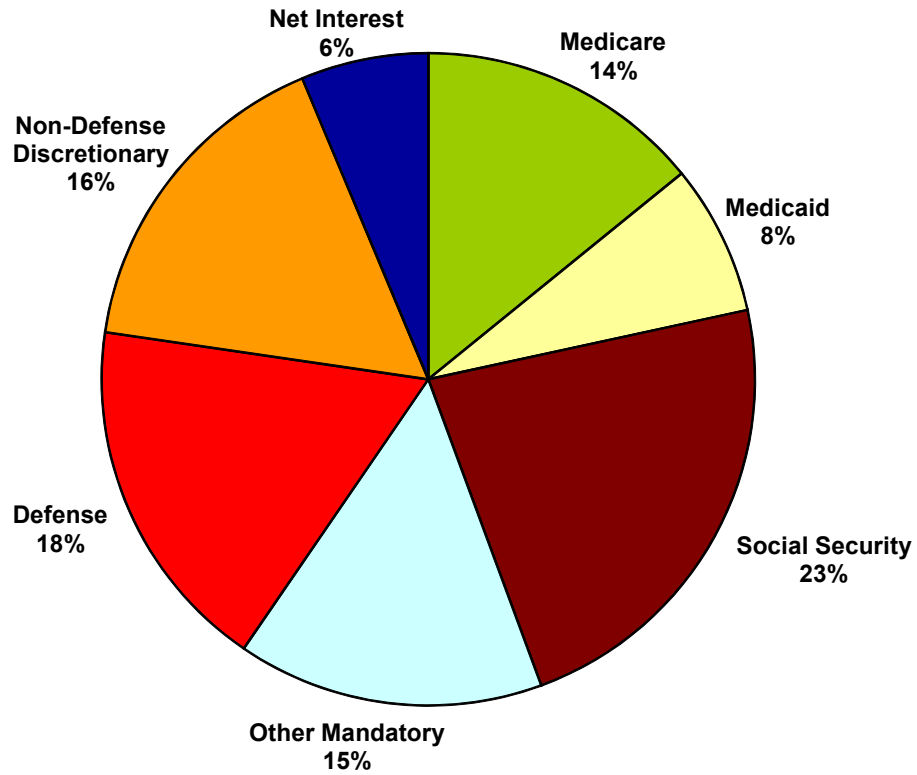
Source: National Commission on Fiscal Responsibility and Reform.

## Credit Rating Agencies On The Possibility Of A Future U.S. Downgrade

Ratings Agency	U.S Credit Rating Will Be Downgraded If...
Moody's	<p>“There would be a risk of downgrade if (1) there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the US government's funding costs over and above what is currently expected.” – Aug 2, 2011</p> <p>“However, as \$1.2 trillion in further deficit reduction has already been legislated through automatic spending caps if no agreement is reached, failure by the committee to reach agreement would not by itself lead to a rating change.” – Nov 1, 2011</p> <p>"[F]iscal package passed by both houses of Congress yesterday is a further step in clarifying the medium-term deficit and debt trajectory of the federal government. It does not, however, provide a basis for a meaningful improvement in the government's debt ratios over the medium term...On the other hand, lack of further deficit reduction measures could affect the rating negatively.” – Jan 2, 2013</p>
S&P	<p>“The outlook on the long-term rating is negative. We could lower the long-term rating to 'AA' within the next two years if we see that less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory than we currently assume in our base case.” – Aug 5, 2011</p> <p>“[W]e expect the caps on discretionary spending as laid out in the Budget Control Act of 2011 to remain in force. If these limits are eased, downward pressure on the ratings could build.” – Nov 21, 2011</p> <p>“While Congressional compromise designed to avoid the "fiscal cliff" may support the still-fragile U.S. economic rebound, the compromise doesn't affect our view of the country's credit outlook, given that we believe yesterday's agreement does little to place the U.S.'s medium-term public finances on a more sustainable footing.” – Jan 2, 2013</p>
Fitch	<p>“[F]ailure to reach agreement in 2013 on a credible deficit reduction plan and a worsening of the economic and fiscal outlook would likely result in a downgrade of the U.S. sovereign rating.” – Nov 28, 2011</p> <p>“Absent material adverse shocks, Fitch does not expect to resolve the Negative Outlook until late 2013. Fitch will take into account any deficit-reduction strategy that may emerge after Congressional and Presidential elections in addition to an updated assessment of the medium-term economic and fiscal outlook. Agreement on a multi-year deficit reduction plan that would stabilise government indebtedness and secure confidence in the long-run sustainability of public finances would likely result in Fitch affirming U.S. 'AAA' status and revising the Rating Outlook to Stable. Conversely, failure to secure agreement on deficit-reduction that implies a continuing rise in government indebtedness over the remainder of the decade would likely result in Fitch downgrading the U.S. sovereign rating.” – July 10, 2012</p> <p>“Implementation of the automatic spending cuts - the sequester - and a government shutdown would not prompt a negative rating action. But such an outcome would further erode confidence that timely agreement will be reached on additional deficit reduction measures necessary to secure the 'AAA' rating....a failure to raise the debt ceiling in a timely fashion would prompt a review and likely downgrade of the US sovereign rating.” – February 27, 2013.</p>

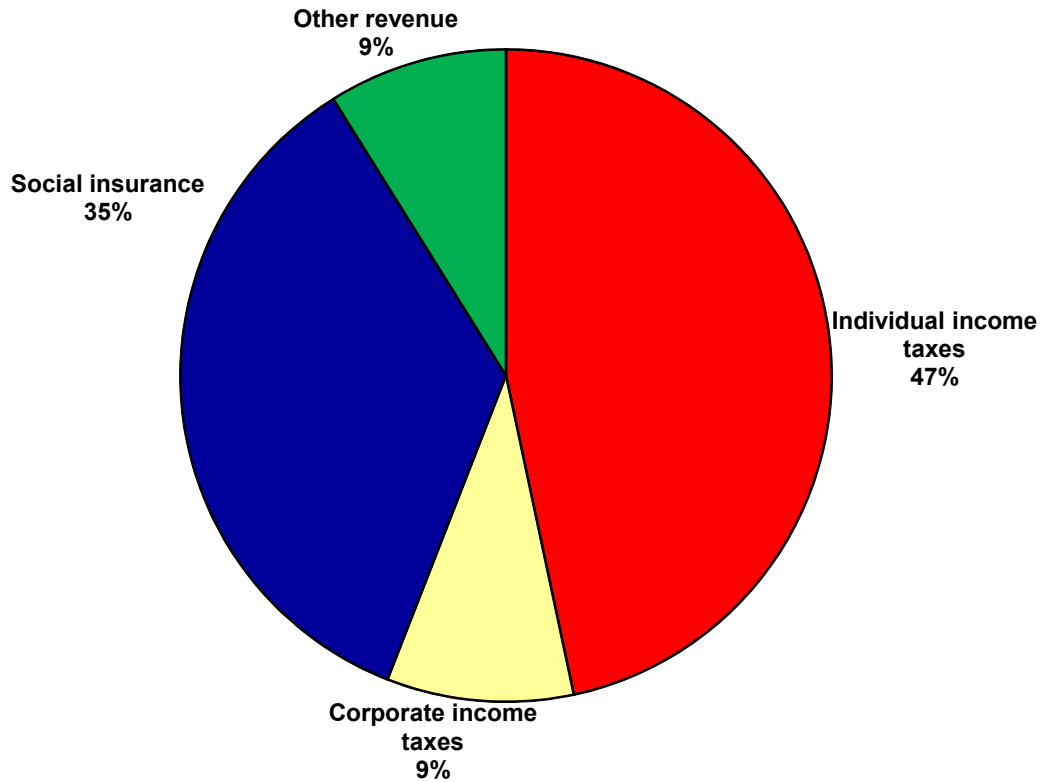


**Federal Budget Outlays - \$3.6 Trillion, FY13 Estimate**



Source: CBO.

**Federal Budget Receipts - \$2.7 Trillion, FY13 Estimate**



Source: CBO.

### Individual Tax Rates Under Various Tax Plans

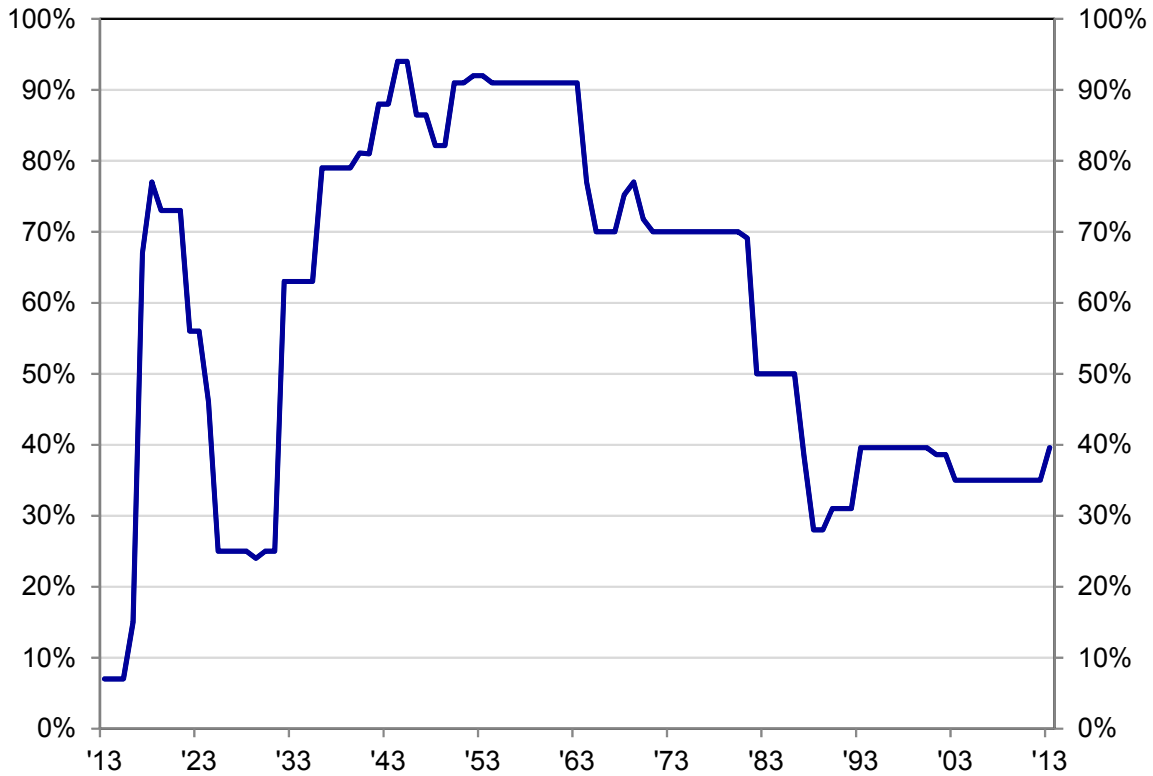
Taxable Income Ranges (Married Filing Jointly)	Actual	Bush Tax Cuts Expire	Obama Budget	Fiscal Cliff Deal
<b><u>'13 Dollars*</u></b>	<b><u>'12</u></b>	<b><u>'13</u></b>	<b><u>'13</u></b>	<b><u>'13</u></b>
Over \$450,000	35	39.6	39.6 <sup>1</sup>	<b>39.6</b>
\$398,350 - \$450,000	35	39.6	39.6 <sup>1</sup>	<b>35</b>
\$223,050 - \$398,350	33	36	36 <sup>1</sup>	<b>33</b>
\$146,400 - \$223,050	28	31	28	<b>28</b>
\$72,500 - \$146,400	25	28	25	<b>25</b>
\$17,850- \$72,500	15	15	15	<b>15</b>
\$0 – 17,850	10	-	10	<b>10</b>
Top dividend rate	15	43.4 <sup>2</sup>	43.4 <sup>2</sup>	<b>23.8<sup>2</sup></b>
Top cap gains rate	15	23.8 <sup>2</sup>	30 <sup>3</sup>	<b>23.8<sup>2</sup></b>
Estate tax rate	35%	55%	45%	<b>40%</b>
Estate exemption	\$5 mil	\$1 mil	\$3.5 mil	<b>\$5 mil</b>

<sup>1</sup> Tax rates would rise on income over \$250,000 for joint filers.

<sup>2</sup> This includes the 3.8% investment tax under the health care law.

<sup>3</sup> This includes Buffett tax.

**Top Marginal Income Tax Rate**



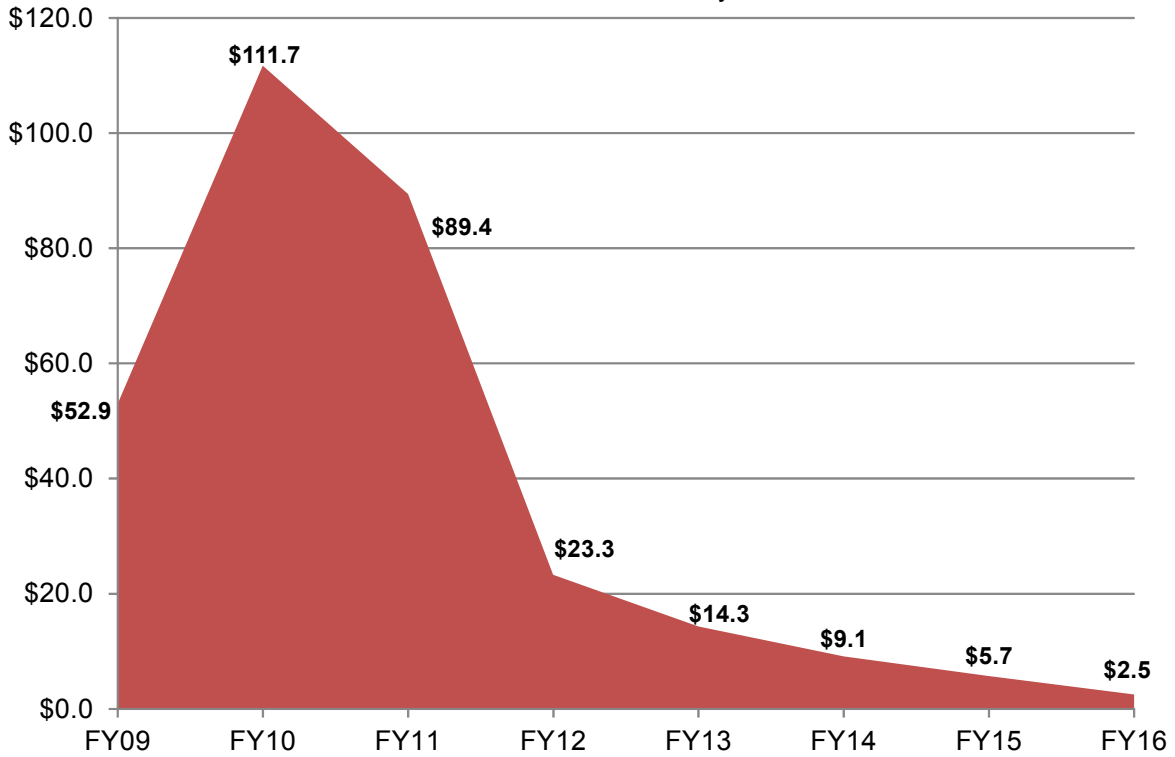
Source: Tax Policy Center. Note: Rates ignore a number of factors, such as income-related reductions in value of itemized deductions and the large increase in percentage of returns that were subject to this top rate.

**Top 10 Individual Tax Expenditures For Fiscal Years 2013-2017**

	<b>5-yr estimate in billions</b>		<b>5-yr estimate in billions</b>
Exclusion of employer contributions for health care	\$760.4	Deduction of state & local govt income, sales, property taxes	\$277.6
Lower rate on cap gains, dividends	\$616.2	Exclusion of capital gains at death	\$258.0
Mortgage interest deduction	\$379.0	Defined benefit pension plans	\$212.2
Defined contribution pension plans	\$335.6	Exclusion of interest on State and local government bonds	\$191.3
Earned income credit	\$325.9	Charitable contributions deduction	\$183.0

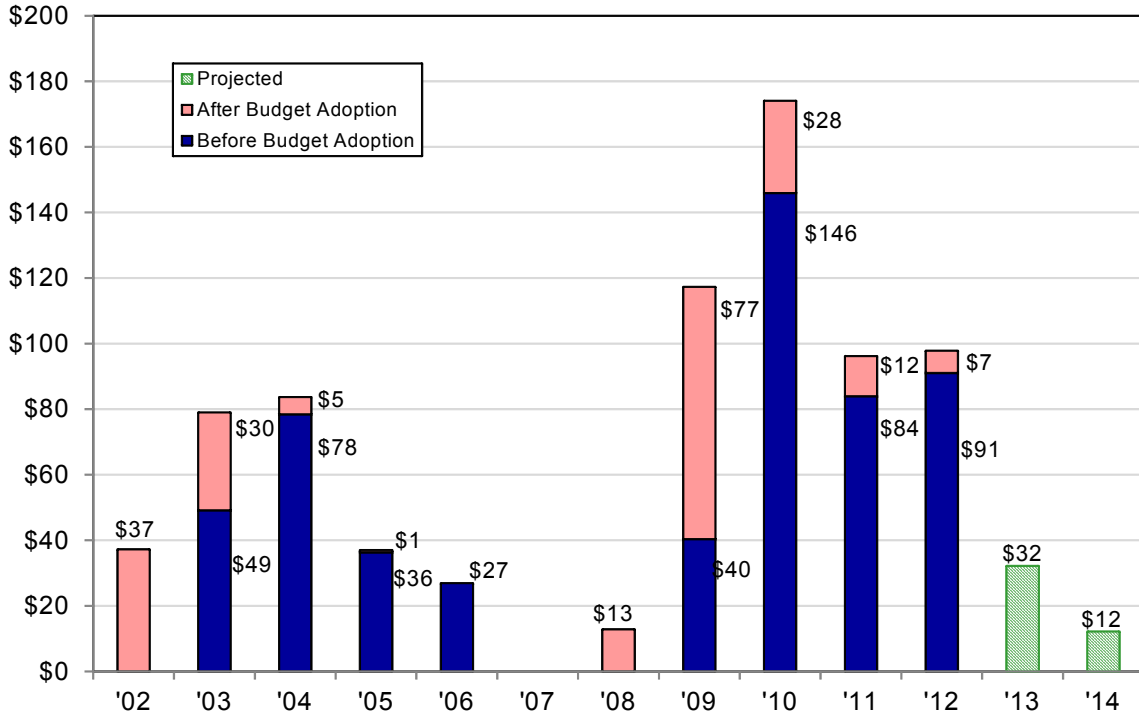
Source: Joint Committee on Taxation.

**Temporary Federal Aid To States Drops**  
in billions of dollars, fiscal years



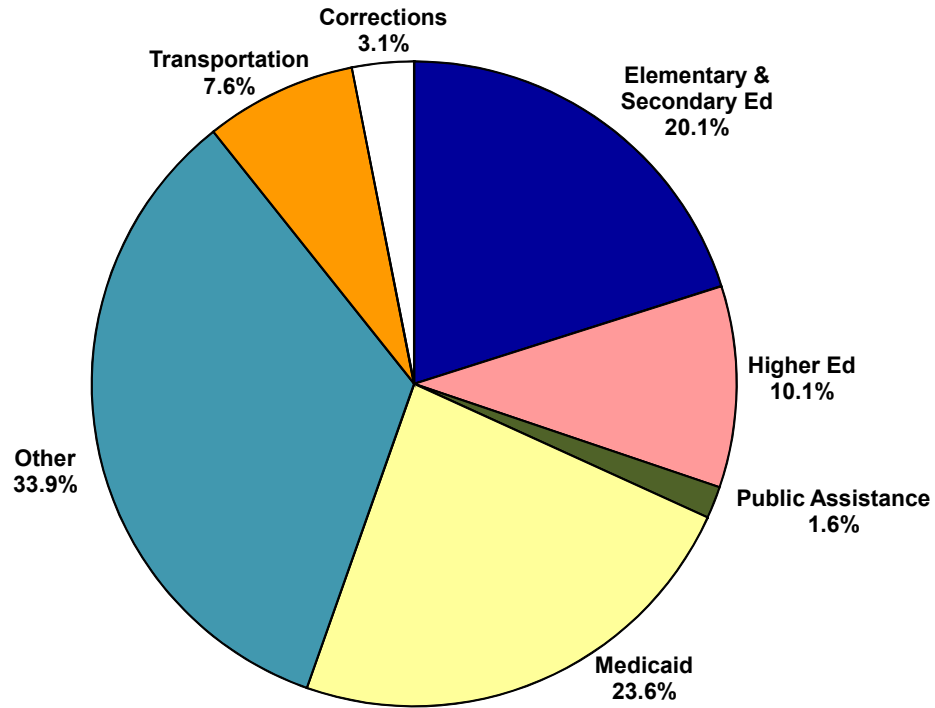
Sources: National Association of State Budget Officers, GAO.  
For 46 states, fiscal year begins July 1. Therefore, FY12 begins July 2011.

**State Budget Gaps Fiscal Years 2002-2014**  
in billions



Source: NCSL.

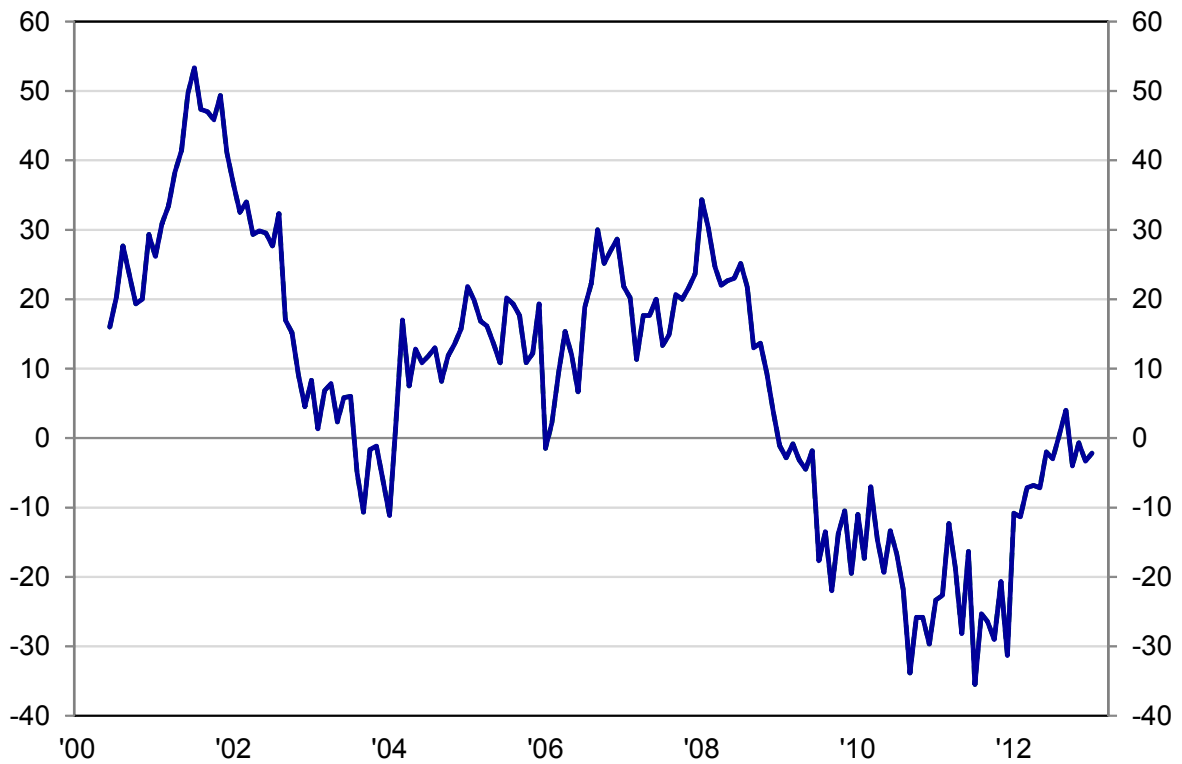
### State Gov't Spending - \$1.7 Trillion, FY11 Estimate



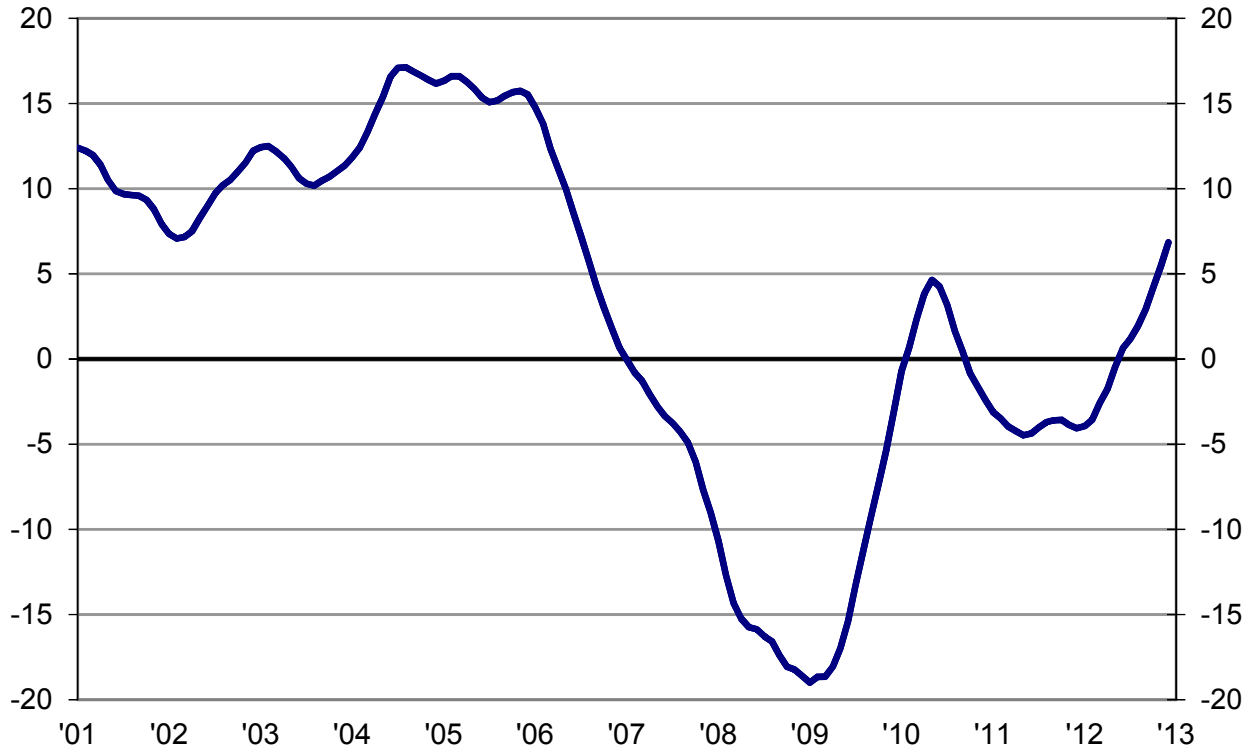
Source: National Assoc. of State Budget Officers.

### State & Local Government Nonfarm Payrolls

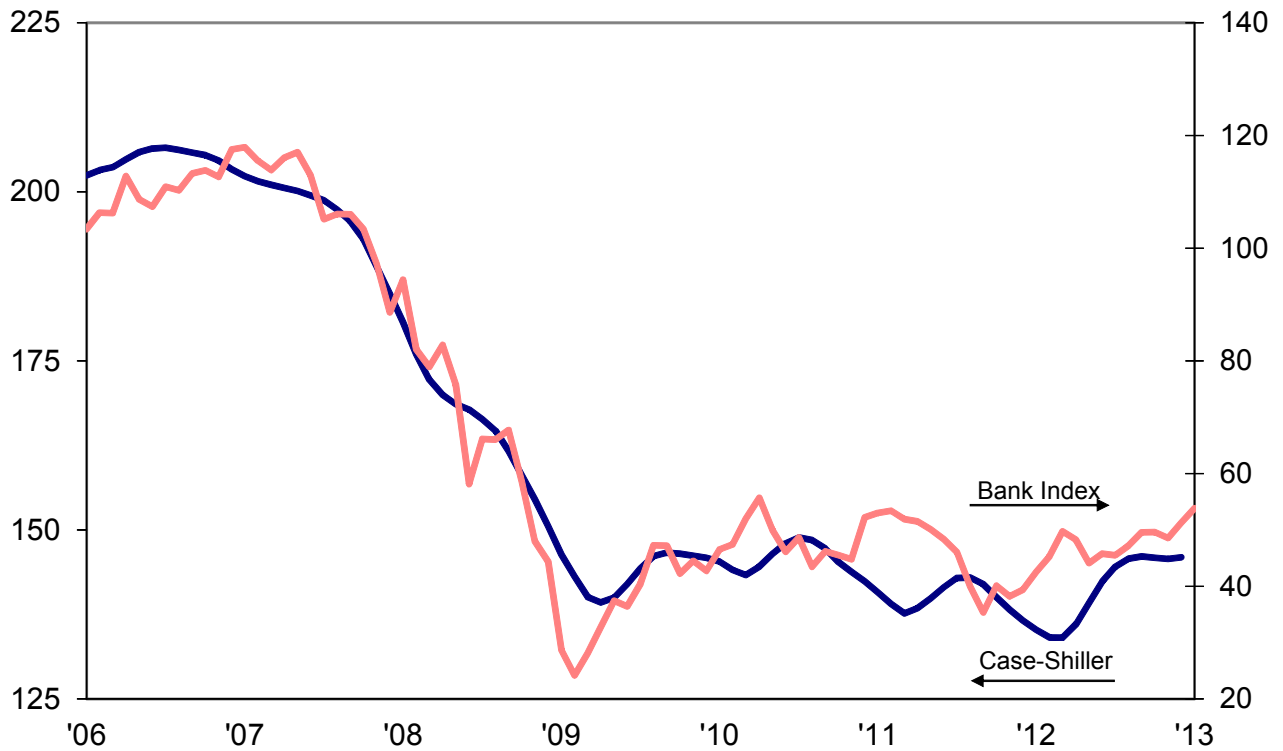
MoM change, 6mo moving avg, in thousands



**S&P/Case-Shiller Home Price Index**  
20-City Composite, Y/Y%, through December



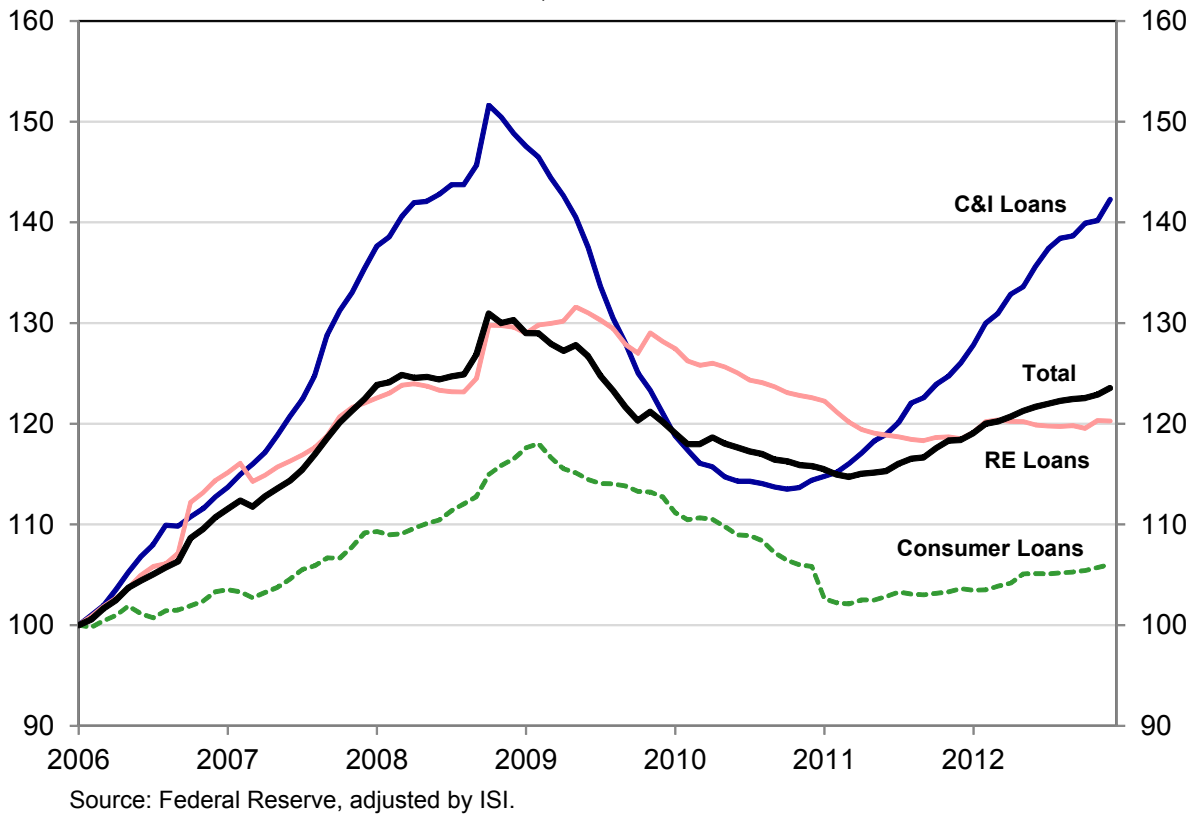
**S&P/Case-Shiller Home Price Index and KBW Bank Index**  
20-City Composite through December



**FHA Mortgages for Purchase As Share Of Total Originations**



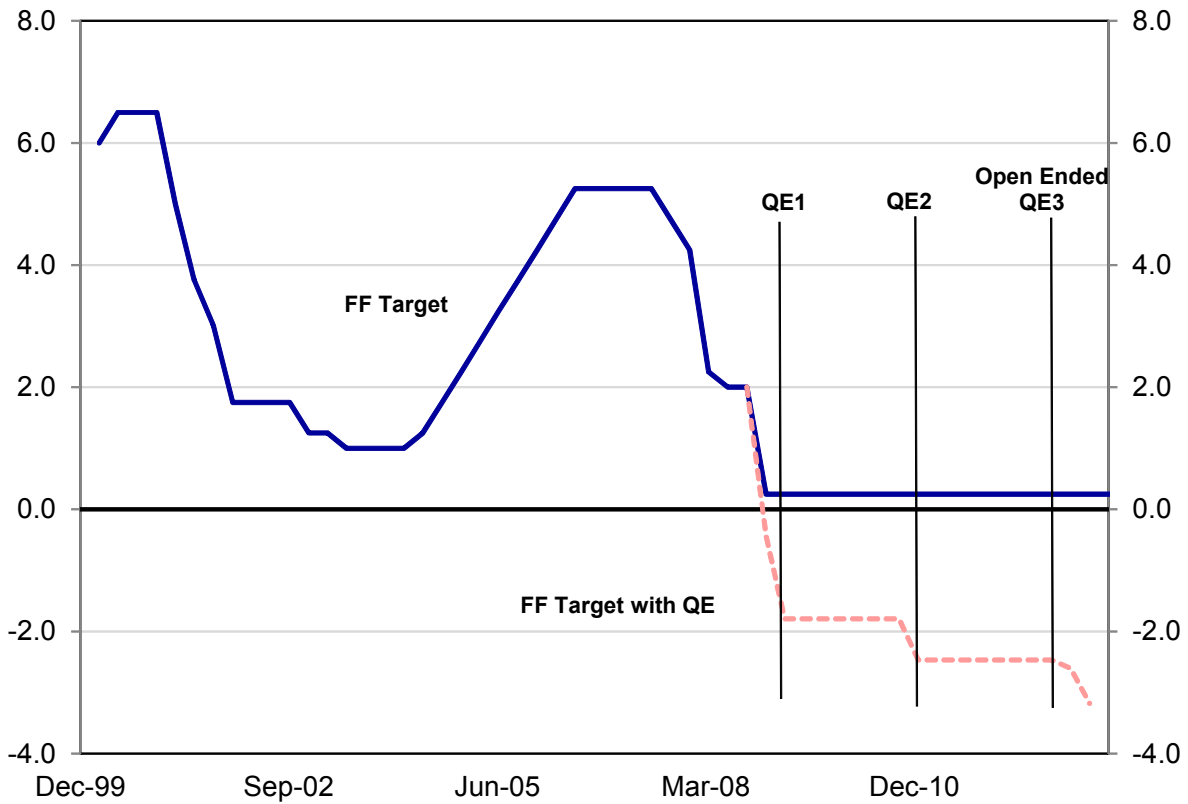
**US Bank Lending**  
indexed, Jan 2006 = 100



Real Fed Funds Using Core CPI



Federal Funds Rate Target with QE



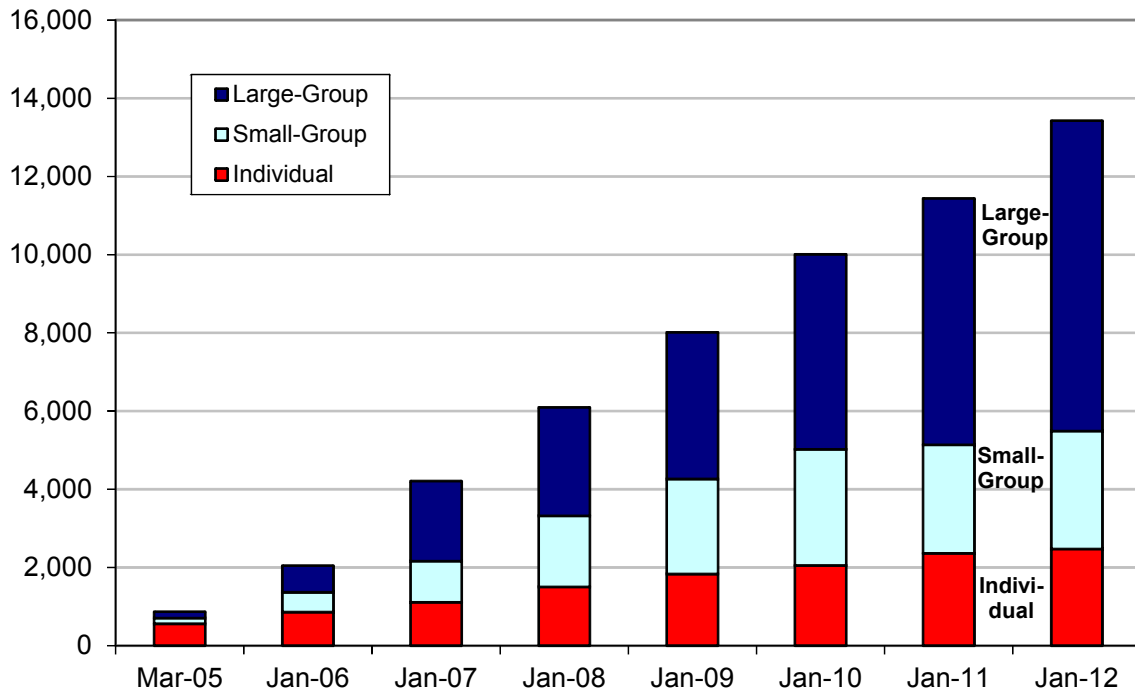


**Personal Health Expenditures 2011**  
(in billions)

Source of Funds	Total	Hospital Care	Physician & Clinical	Dental & Other Prof Svc	Drugs	Durable & Other Med. Equip.	Home Health	Nursing Homes	Other Personal Care
<b>Personal Health Care Expenditures</b>	2,279.3	850.6	541.4	181.6	263.0	85.9	74.3	149.3	133.1
<b>Out-Of-Pocket</b>	307.7	28.1	52.3	64.1	45.0	65.1	5.6	39.9	7.5
<b>Health Insurance</b>	1,779.1	742.4	440.3	110.5	214.3	20.2	66.5	100.4	84.5
<b>Private Insurance</b>	786.1	306.9	249.1	79.4	122.2	4.6	5.1	12.4	6.4
<b>Medicare</b>	521.6	231.3	124.0	16.2	63.7	10.9	32.9	37.6	5.1
<b>Medicaid</b>	374.5	151.0	44.8	12.2	19.0	4.6	27.6	46.1	69.3
<b>Other (CHIP, DoD, VA)</b>	97.0	53.3	22.5	2.7	9.4	0.1	0.9	4.3	3.8
<b>Other 3<sup>rd</sup> Party Payers, Programs</b>	192.5	80.0	48.8	7.0	3.7	0.6	2.2	9.0	41.1

Source: Centers for Medicare and Medicaid Services. Numbers may not add up due to rounding. The figure 0.0 denotes negligible amounts. (-) indicates not applicable.

**HSA/HDHP Enrollment**  
covered lives in thousands



Source: AHIP.

## Health Care Reform Implementation Timeline Under Combined Reconciliation & Senate Bill

Year	Major Reform Measures
<b>2010</b>	<ul style="list-style-type: none"> <li>• Prohibits HMOs dropping coverage when person gets sick.</li> <li>• Rebates for Part D enrollees who enter donut hole.</li> <li>• Extends dependent coverage for children up to age 26.</li> <li>• Small business tax credit for qualified employers.</li> <li>• Closes black liquor tax loophole.</li> <li>• Tax on indoor tanning services effective July 1.</li> </ul>
<b>2011</b>	<ul style="list-style-type: none"> <li>• Tax on prescription drug companies.</li> <li>• Reduction in market basket updates for hospitals and other providers.</li> <li>• Freezes 2011 MA payment benchmarks to 2010 levels.</li> <li>• 50% discount on drugs in donut hole.</li> <li>• Increases tax for early HSA and Archer MSA withdrawals for nonqualified medical expenses from 10% to 20% and 15% to 20%, respectively.</li> </ul>
<b>2012</b>	<ul style="list-style-type: none"> <li>• CMS to reduce avoidable hospital readmissions.</li> </ul>
<b>2013</b>	<ul style="list-style-type: none"> <li>• New Medicare taxes on wages and investment income.</li> <li>• Tax on medical device companies.</li> <li>• Adoption and implementation of uniform health IT standards and business rules.</li> <li>• Limits FSA contributions to \$2,500/year, indexed to inflation.</li> <li>• Eliminates deduction for employer Part D subsidy.</li> </ul>
<b>2014</b>	<ul style="list-style-type: none"> <li>• Tax on HMOs.</li> <li>• Establishes Exchanges.</li> <li>• Strong insurance regulations – prohibits HMOs from refusing to sell or renew policies due to individual’s health status; plans cannot exclude coverage for treatments based on pre-existing conditions; companies can’t charge higher rates due to health status, gender or other factors.</li> <li>• Individual and employer mandates.</li> <li>• Provides premium tax credits through the Exchange for those individuals above Medicaid eligibility but below 400% of poverty.</li> <li>• Health plans may not impose annual limits on amount of coverage an individual may receive.</li> <li>• Expands Medicaid eligibility.</li> <li>• Reduces disproportionate share hospital (DSH) payments.</li> </ul>
<b>2015</b>	<ul style="list-style-type: none"> <li>• Creates program to pay physicians based on value not volume.</li> <li>• Establishes Independent Payment Advisory Board.</li> </ul>
<b>2018</b>	<ul style="list-style-type: none"> <li>• Tax on high-cost insurance plans (Cadillac tax).</li> </ul>

Source: House Energy and Commerce Committee.

### State Participation Under Health Care Reform Law

<u>Program</u>	<u># of States</u>	<u>Comment</u>	<u>% of National Population</u>
<b><u>Exchanges:</u></b>			
State-run exchanges	18	CA, CO, CT, DC, HI, ID, KY, MD, MA, MN, NV, NM, NY, OR, RI, UT, VT, WA	35.8%
State-Federal partnership	7	AR, DE, IL, IA, MI, NH, WV	10.6%
Federal exchange	26	AL, AK, AZ, FL, GA, IN, KS, LA, ME, MS, MO, MT, NE, NJ, NC, ND, OH, OK, PA, SC, SD, TN, TX, VA, WI, WY	53.6%
<b><u>Medicaid Expansion:</u></b>			
Yes	24	AZ, AR, CA, CO, CT, DE, DC, FL, HI, IL, MD, MA, MI, MN, MO, MT, NV, NH, NM, ND, OH, RI, VT, WA	48.9%
Lean Yes	3	KY, NY, OR	8.9%
No	13	AL, GA, ID, LA, ME, MS, NC, OK, PA, SC, SD, TX, WI	28.2%
Lean No	5	IA, NE, NJ, VA, WY	7.2%
Undecided	6	AK, IN, KS, TN, UT, WV	6.8%

Sources: Kaiser - exchange data as of Feb. 15, 2013; Advisory Board - Medicaid data as of Feb. 20, 2013.

### Tax Provisions In Health Care Law

In billions of dollars

<u>Effective Date</u>	<u>Provision</u>	<u>2010-19 Revenue</u>
2011	Pharmaceutical Tax	\$27
2013	Limit on FSAs	\$13
2013	Medical Device Tax	\$20
2013	Individual Medicare Tax	\$210
2014	HMO Tax	\$60
2018	Excise Tax on High-Cost Plans	\$32

Source: Joint Committee on Taxation.

### Insurance Coverage Under Passed Health Care Plan

EFFECTS ON INSURANCE COVERAGE /a (Millions of nonelderly people, by calendar year)		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Current Law Coverage /b	Medicaid & CHIP	40	39	39	38	35	34	35	35	35	35
	Employer	150	153	156	158	161	162	162	162	162	162
	Nongroup & Other /c	27	26	25	26	28	29	29	29	30	30
	Uninsured /d	<u>50</u>	<u>51</u>	<u>51</u>	<u>51</u>	<u>51</u>	<u>51</u>	<u>52</u>	<u>53</u>	<u>53</u>	<u>54</u>
	TOTAL	267	269	271	273	274	276	277	279	281	282
Change (+/-)	Medicaid & CHIP	*	-1	-2	-3	10	15	17	16	16	16
	Employer	*	3	3	3	4	1	-3	-3	-3	-3
	Nongroup & Other /c	*	*	*	*	-2	-3	-5	-5	-5	-5
	Exchanges	0	0	0	0	8	13	21	23	24	24
	Uninsured /d	*	*	-1	-1	-19	-25	-30	-31	-31	-32
<u>Post-Policy Uninsured Population</u>											
	Number of Nonelderly People /d	50	50	50	50	31	26	21	21	22	23
	Insured Share of the Nonelderly Population /a										
	Including All Residents	81%	82%	82%	82%	89%	91%	92%	92%	92%	92%
	Excluding Unauthorized Immigrants	83%	83%	83%	83%	91%	93%	95%	95%	95%	94%

Source: CBO.

### Comparison Of Subsidies Under Health Bill

Family of Four – 2016

<b>Compensation in Cash &amp; Employer-provided Insurance (approximate)</b>	<b>\$ 42,000</b>	<b>\$ 60,000</b>	<b>\$ 78,000</b>	<b>\$ 96,000</b>
Value of Subsidy under PPACA	\$ 12,512	\$ 6,805	\$ 4,221	\$ 2,322
Value of Tax Subsidy under Employer-Provided Plan	\$ 5,536	\$ 3,545	\$ 3,545	\$ 3,545
<b>Net Gain/Loss from Exchange</b>	<b>\$ 6,976</b>	<b>\$ 3,261</b>	<b>\$676</b>	<b>\$(1,222)</b>

Source: C. Eugene Steuerle and Stephanie Rennane, Urban Institute 2010. Authors calculations based on data from CBO and the Patient Protection and Affordable Care Act. Net Gain/Loss is net of the employer penalty for not providing health insurance.

## Oil & Gas Tax Hikes In Obama FY13 Budget

in billions of dollars

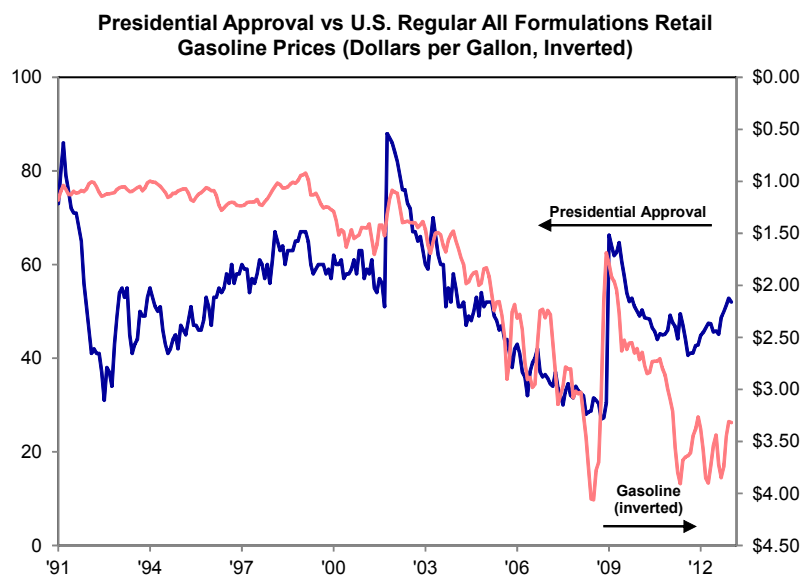
Proposal	Tax Revenue (over 10 years)
Eliminate expensing of intangible drilling costs	\$13.9
Eliminate domestic manufacturing deduction for oil and natural gas companies	\$11.8
Eliminate percentage depletion for oil and natural gas wells	\$11.5
Increase geological and geophysical amortization period for independent producers to seven years	\$1.4

Source: OMB.

## Breakdown of Key Sources of Direct Greenhouse Gas Emissions by Economic Sector in the US (2007)

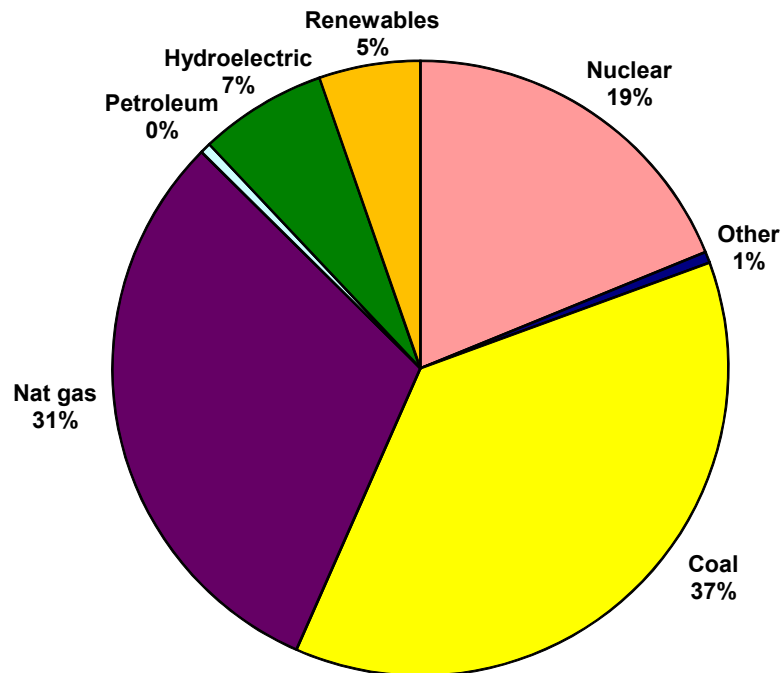
	<u>Share</u>
<b>Electricity Generation</b>	<b>34%</b>
Coal	28%
Natural Gas	5%
Petroleum	1%
Other Electricity Generation	1%
<b>Transportation</b>	<b>28%</b>
Passenger Cars	9%
Light-Duty Trucks	8%
Other Trucks and Buses	6%
Other Transportation	5%
<b>Industry</b>	<b>19%</b>
Other Industrial	8%
Chemical Manufacturing	5%
Petroleum Refining	3%
Fossil Fuel Exploration & Production	3%
<b>Agriculture</b>	<b>7%</b>
Agricultural Soil Management	3%
Livestock	3%
Other Agriculture	1%
<b>Commercial</b>	<b>6%</b>
Other Commercial	3%
Waste Services	2%
Office & Service	1%
<b>Residential</b>	<b>5%</b>

Source: EPA; House Energy and Commerce.



### Net Electricity Generation By Source

Year-To-Date Through November 2012



Source: EIA.

### Significant EPA Rules

Rule	Description	Expected Timeline	Possible Impact
Cross-State Air Pollution	Requires power plants to reduce emissions that affect the ozone.	D.C. circuit court struck down this rule on Aug 21, 2012. US Court of Appeals for DC Circuit declined to rehear case on Jan 24. EPA may choose to appeal to US Supreme Court or draft new rule.	Consumer rate increases, but legal outlook unclear.
Cooling Intake Structures	Existing cooling intake structures must limit organism fatalities.	Rule to be finalized by June 2013.	Early power plant retirements and decreased US electrical capacity.
Greenhouse Gas Performance Standards	Limit GHG emissions for new/modified electric power plants and refineries.	Rules to be finalized March 2013.	Accelerates move from coal-fired to natural-gas run plants.
Coal Combustion Residuals (CCR)	Enhance CCR and coal ash regulations.	EPA Administrator Jackson indicated that the rule will be released "later in the year [2012]."	CCR 'special waste' classification probably leads to more closures, while 'non-hazardous' likely means just minor modifications.
Ozone Air Quality Standards	Revise primary ozone level standard from 75 parts per a billion (ppb) to somewhere in the range of 70 to 60 ppb.	Final revisions delayed until 2013.	96% of monitored counties become non-compliant if standard set at 60 ppb; changes may lead to production declines.

## Summary Of Election Results

### Electoral College Count

	<u>Won</u>
Obama	332
Romney	206

### Popular Vote

	<u>Vote</u>	<u>Vote %</u>
Obama	62,615,406	51
Romney	59,142,004	48

### Senate

	<u>Old</u>	<u>New</u>
Dem	53	55
GOP	47	45

### House

	<u>Old</u>	<u>New</u>
GOP	240	234
Dem	190	201
Vacancy	5	-

### Demographic Breakdown (2012 Exit Polls)

	<u>Share of Voters</u>	<u>Obama</u>	<u>Romney</u>
White Men	34%	35%	62%
White Women	38%	42%	56%
Other	28%	82%	18%

Source: Fox Exit Poll.

## Exit Polls

### Vote by Party ID

2012		
	Dem	GOP
Democrat (38%)	92	7
Republican (32%)	6	93
<b>Independent (29%)</b>	<b>45</b>	<b>50</b>
2010		
	Dem	GOP
Democrat (35%)	91	7
Republican (35%)	5	94
<b>Independent (29%)</b>	<b>37</b>	<b>56</b>
2008		
	Obama	McCain
Democrat (39%)	89	10
Republican (32%)	9	90
<b>Independent (29%)</b>	<b>52</b>	<b>44</b>
2006		
	Dem	GOP
Democrat (38%)	93	7
Republican (36%)	8	91
<b>Independent (26%)</b>	<b>57</b>	<b>39</b>
2004		
	Kerry	Bush
Democrat (37%)	89	11
Republican (37%)	6	93
<b>Independent (26%)</b>	<b>49</b>	<b>48</b>

Source: CNN.

### Exit Polls on the Role of Gov't

Govt should do...	2000	2004	2008	2010	2012
More	43	46	51	38	43
Less	53	49	43	56	51

Source: CNN.



### Voting Results of Swing States

State	EV	GOP Electoral Votes	Romney Pop. Vote Margin	State Margin Relative To National
<b>National</b>	<b>538</b>	<b>206</b>	<b>-3.84</b>	<b>NA</b>
GA	16	190	7.82	11.66
NC	15	206	2.04	5.88
FL	29	235	-0.88	2.96
OH	18	253	-2.98	0.86
VA	13	266	-3.87	-0.03
CO	9	275	-5.37	-1.53
PA	20	295	-5.38	-1.54
NH	4	299	-5.58	-1.74
IA	6	305	-5.81	-1.97
NV	6	311	-6.68	-2.84
WI	10	321	-6.84	-3.00
MN	10	331	-7.69	-3.85

## Romney Portfolio

Sector	Percent of Portfolio	Companies	Rationale
Health Care	30	(HCA, HMA, CNC), UNH, LLY, BSX	Hospitals and Medicaid HMOs would be hurt by GOP efforts to overturn the health care law/reverse the expansion of Medicaid and exchange subsidies. HMOs might benefit from major surgery to the ACA and premium support. Mark Schoenebaum notes LLY is among the least exposed to Medicaid (which the GOP would cut) and would disproportionately benefit if the pharma tax were repealed. It's also a big dividend payer. BSX is a lower-margin device company that would benefit from repeal of the device tax.
Energy	20	OII, HOS, CLR, BTU	Romney/ the GOP will try to do more to promote traditional forms of energy, including offshore drilling, approving the Keystone pipeline, and exploiting the nation's coal resources. A second Obama term could be tough on those sectors.
Financials	10	JPM, BAC	Banks won't get much legislative or regulatory relief if Romney wins, but Ed Najarian says reduced risk under the GOP would boost sentiment.
Telecom	10	VZ, T	Bill Whyman notes that the FCC has been aggressive under Obama on net neutrality, antitrust and other issues. A Romney win could mean a tamer FCC and lower dividend tax rates.
Alternative Energy	10	(VWSYF, FSLR)	Romney has pledged to oppose extension of the PTC (which benefits wind energy companies) and has been skeptical of favors for alternative energy.
Tax Reform	10	(TOL), CSCO	Stephen East says a high-end homebuilder like TOL is most at risk from limiting the mortgage deduction for the wealthy. Brian Marshall says 90% of CSCO's cash is stranded overseas, so it would benefit disproportionately from a repatriation holiday, which is more likely under the GOP.
Fed Policy	5	SCHW	A Romney win could mean a slightly more hawkish Fed when Bernanke's term is up. Brian Bedell notes SCHW would benefit from higher short-term rates, lower tax rates on investment income, and a Romney equity market rally.
China Trade	5	(COH)	A trade war with China is unlikely, but trade tensions could rise under Romney. Omar Saad notes that a company like COH, which manufactures most of its products in China and imports them to the US, is potentially at risk.

The indexes consist of 20 stocks, each equal-dollar weighted. Companies that appear in parentheses are short positions.

## Obama Portfolio

Sector	Percent of Portfolio	Companies	Rationale
Taxes	25	(TIF, DVY, AMZN, EPD) LNC	Higher taxes on the wealthy under Obama could hurt TIF more than other retailers according to Omar Saad. Dividend payers could also suffer. Greg Melich believes fears are overblown for AMZN if Congress allows taxation of Internet sales, but the proposal is more likely under Democrats and the stock would probably come under pressure if a bill advances through Congress. Energy MLPs have long been an Obama target. Insurers will sell more annuities and life insurance policies if tax rates on income and estates are higher.
Defense	20	(NOC, GD, SAI, OFC)	Traditional defense companies and national-security oriented tech companies would likely do better under GOP government. Steve Sakwa notes OFC is highly levered to national security spending.
Discretionary Spending	15	ILMN, ARE, SWY	Ross Muken notes ILMN is levered to the NIH budget, which would likely be higher under Obama. Steve Sakwa says ARE would benefit from higher NIH spending, too. Grocery stores would benefit from more generous food stamps and a more pro-union NLRB (which could hurt non-unionized competitors like WMT.)
Natural Gas Fracking	15	(HAL, NBR, PTEN)	Jud Bailey notes these companies are highly leveraged to fracking and onshore drilling in the US, which could be negatively impacted if regulatory costs are substantially higher in a second Obama term.
Infrastructure	15	VMC, GVA, ASTE	Infrastructure spending is a big priority of Obama's and would likely do better if he wins than under a GOP-oriented government.
Utilities	10	(SO), EXC	High-dividend payers like SO that have coal generation could be hurt by higher dividend tax rates and tougher environmental rules. Nuclear generation accounts for about 80% of EXC generation according to Greg Gordon, so it could benefit if the EPA under Obama makes coal and natural gas production more expensive.

The indexes consist of 20 stocks, each equal-dollar weighted. Companies that appear in parentheses are short positions.